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Report on the Underground Economy in Ontario, 1993-1994

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ASSEMBLÉE LÉGISLATIVE

TORONTO, ONTARIO

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The Honourable David Warner, M.P.P.
Speaker of the Legislative Assembly

Sir,

Your Standing Committee on Finance and Economic Affairs has the honour to present its Report on the Underground Economy in Ontario, 1993-1994 and commends it to the House.

A handwritten signature in cursive script, reading 'Paul R. Johnson'.

Paul R. Johnson, M.P.P.
Chair

Queen's Park
February, 1994

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INTRODUCTION

The Standing Committee on Finance and Economic Affairs is pleased to present a report on its investigation of the underground economy in Ontario.

The Committee's decision to examine the underground economy was prompted by growing interest on the part of the Ontario and federal governments in the root causes of revenue losses. The Committee also had concerns about negative public perceptions of the tax system, the increasing incidence of reports of deliberate tax evasion, and the smuggling and sale of illegal tobacco and beverage alcohol products. Members wished to consult with a broad range of witnesses in order to comprehend the size of the problem, the reasons for concern, the contributing factors, and what corrective actions, if any, could be taken.

Hearings began on October 21, 1993, with a detailed presentation by staff from the provincial Ministry of Finance. A further five days gave Committee members the opportunity to discuss the issue with representatives from government agencies and the private sector, and academics. In order to be more conversant with specific aspects of the underground economy, Committee members reviewed various articles and reports. A bibliography of these works appears in Appendix A.

This report is not a definitive study of the underground economy. Rather, it should be recognized as a first attempt to come to grips with the complexities of the issue, based on six days of public hearings.

The Committee would like to thank those groups and individuals who participated in its precedent-setting hearings on the underground economy. Their contributions shed new light on what many consider a growing economic and social problem.

DEFINITIONS

In its attempt to define the underground economy, the Committee heard differing opinions. Despite the differences, there was agreement that both legal and illegal activities are hidden or unreported. While the Committee recognizes this duality, its intent is to examine the issue of tax evasion as opposed to tax avoidance.

The Committee considered the definition provided by the Ministry of Finance to be the one that most closely reflected its intent.

Any intentional non-compliance with tax statutes, ranging from late and non-payment of reported tax liabilities at one end of the spectrum to deliberate tax evasion at the other extreme.

Among the other contributions heard by the Committee was that of Professor François Vaillancourt, an economist from the University of Montreal. He told the Committee that the definition depended in part on the measurement technique used. For example, a survey would provide information on work force participation in legal activities that were unreported for tax purposes. Monetary aggregates measure legal or illegal activities conducted in or outside of the country and paid for in cash, by analyzing the amount of excess currency and the relationship between currency and activities.

Professor Jack Mintz, Faculty of Management, University of Toronto, said most people think the underground economy is the use of cash or the non-reporting of income in order to hide something that would normally be recorded with receipts. While he thinks that this might be a useful public policy definition, Mintz does not think it is comprehensive enough. The issue should be considered in terms of formal and informal markets, the former involving recorded transactions, the latter conducted in cash with no records.

Other witnesses spoke of the legal activities that they considered part of the underground economy. These include self-performed services such as car repairs, home renovations, volunteer services, and other informal exchanges. The illegal portion of legal activities is the tax that is evaded.

Bartering was the subject of some debate during the hearings. There were witnesses who considered it part of the underground economy. Others, including some Committee members, spoke of its aboveground nature as practised in rural areas. In the opinion of the Local Employment and Trading System (LETS), its formal bartering system is parallel to the aboveground economy. Where required, the goods and services tax (GST) and the provincial sales tax (PST) are paid.¹

The terms "tax avoidance" and "tax evasion" were used interchangeably in some of the literature reviewed for the Committee and by some witnesses. There were others who saw tax evasion as an illegal act and tax avoidance as the pursuit of legitimate deductions to reduce taxes.

SIZE OF THE UNDERGROUND ECONOMY

Due to its hidden nature, it is inherently difficult to measure the size of the underground economy. Attempting to establish what portion would be due to unreported taxes was described as an even greater mystery. There did, however, seem to be a consensus of opinion that activity had increased significantly in recent years and continued to grow as a percentage of gross domestic product (GDP).²

¹LETS provided the Committee with a Revenue Canada bulletin dated July 5, 1982. It outlined the Department's views on the income tax implications arising from bartering.

²The Canadian Federation of Independent Business reported on a survey it conducted in 1992. Preliminary data indicated that growth in the Canadian underground economy over the previous three years was in the order of \$40 million.

Formal measures were discussed in presentations made by the Ministry of Finance and members of the academic community. Individuals, groups and organizations representing a number of economic sectors, including jewellery and trucking, appeared with anecdotal evidence of the size of the underground economy. The experiences of witnesses from the construction, beverage alcohol and tobacco sectors were particularly revealing.

Formal Measures

Staff from the Ministry of Finance provided the Committee with an overview of the methodologies used to estimate the size of the underground economy. Related presentations were made by economists.

Ministry of Finance

The Ministry focussed its attention on what it considered the four main approaches used for measurement purposes. Surveys function as guides to public attitudes. They are not considered a good way to measure total size as people can lie or refuse to answer specific questions.³ Labour force analysis is a technique employed by Statistics Canada to count the number of people working in occupational groups. Ministry personnel felt this methodology could provide only a very rough "guestimate" of the proportion of workers in the underground economy. Intensive audits of scientifically chosen random samples of taxpayers were described as being, in many ways, the most attractive methodology. Conducted every 10 years by the American Internal Revenue Service, they are expensive and not available in Canada.

The most widely used and available methodology in Canada is an analysis of the cash in circulation relative to other monetary aggregates. The logic is that

³In his presentation, Professor Anthony Doob from the University of Toronto agreed that the use of survey methodology was not appropriate for calculating the size of the underground economy.

participants in the underground economy almost always use cash. Ministry staff described the three principal subgroups within this methodology. The transactions approach was considered questionable. It assumes a rigid relationship between financial volume and actual transactions. It is based on a base year of approximately 1930 when it assumes there was no underground economy. This approach has led to estimates of the underground economy as being 22% of Canadian GDP.

The currency ratio approach was described as intuitively more plausible. It uses the ratio of cash in circulation relative to other measures. It correlates changes in cash with changes in tax rates. A problem with this approach is the speed at which money circulates under and aboveground. Some studies have assumed that velocity is the same in each. Ministry staff felt it was much slower underground.

The ratio of cash balances approach looks at the total cash held and its ratio to reported consumer expenditure. Peter Spiro, one of the Ministry staff present at the hearings, described his use of this approach in a recently released study.⁴ The ratio saw its largest increase in the last two years, beginning in the first quarter of 1991 and coinciding with the introduction of the GST. (It had been in a steady decline since 1953, when figures first became available.)

Spiro's estimates indicated that since 1991, the underground economy has increased by approximately 1.5% of GDP, a figure he feels may be at the low end of estimates. In summarizing estimates based on monetary studies, the Ministry said the plausible range was 8% to 15% of Canadian GDP.⁵

⁴Spiro's article was summarized for the Committee. See Appendix A.

⁵Canadian real GDP was \$560.0 billion in 1992. (See Ontario, Ministry of Finance, *Ontario Economic Outlook* (Toronto: The Ministry, November 1993), p. 84.) The Ministry's plausible range of 8% to 15% of national GDP would represent \$44.8 billion to \$84.0 billion in 1992.

Other Presentations

François Vaillancourt noted that the monetary aggregates approach employed by himself and others showed increases in the 1990s as compared to the 1980s. Estimates fell within a range of 7% to 20% of GDP. Vaillancourt's personal preference was at the lower end, 7.5%, which represented \$50 billion to \$55 billion in 1992. This figure was based on a sectoral as opposed to an overall analysis; he found it difficult to believe it could be above this level.

Professor Roger Smith, an economist from the University of Alberta, discussed his work with Rolf Mirus in the late 1970s. Using a monetary aggregates approach, they estimated that the underground economy represented between 5% and 22% of Canada's GDP in 1976. (Their best guess was somewhere in the vicinity of between 10% and 12%.) Because their 1976 estimates continued to be regularly referred to, the authors wondered how applicable they were to 1990. To answer this question, Mirus and Smith, along with Vladimir Karoleff, updated their work to 1990. While they were aware of the criticisms of the monetary aggregates approach and had limited confidence in it, they felt that no alternative had a clear advantage. Their new set of estimates fell in the range of 15% to 20%, a significant increase in their opinion.⁶ The results were said to be consistent with other studies.

When asked about the current situation, Smith replied that he thought the evidence pointed to another percentage point or two being contributed by the GST. (Prior to the introduction of the GST in January 1991, there was no federal sales tax on services). When asked where activity was centred, Smith felt that as much as 40% of underground activity was found in small businesses.

⁶Mirus, Smith and Karoleff's range of 15% to 20% of national GDP in 1990 would represent \$85.8 billion to \$113.1 billion, as real GDP was \$565.6 billion that year. (See footnote 5 for source.)

Key Economic Sectors

The construction sector, particularly home renovations, is a major example of the extent of the underground economy in service-related activities. Beverage alcohol and tobacco products are the most common contraband commodities in Ontario.

Construction

The Ontario Home Builders' Association (OHBA) has more than 3,800 members. Approximately 1,700 are found in the builder/contractor/renovator category. In the summer of 1993, the OHBA conducted a mail survey of a random sample of its membership in that category, on the issue of the underground economy.⁷

Respondents were asked to comment on the likelihood of being asked for a "deal." (The most commonly reported deal was that of the purchase of a house that a builder has built for him/herself. Homes built for self-occupation do not require the payment of Ontario New Home Warranty fees. When these homes are sold, there is no GST charged since they are considered resales.) Twenty-eight percent of the builders who responded reported that they were asked for a deal on most jobs or often. Among renovators, 57% were asked on most jobs or often; the percentage among contractors or sub-trades was 38.

The OHBA told Committee members that it conservatively estimated that the tax loss on renovations and probably new home construction, was in excess of \$1 billion. Some renovators have found that their counterparts in the underground have undercut them by 40% to 50% through the use of cash and the non-payment of GST and PST. Further cost reductions are incurred through evading the payment of various employer taxes.

⁷The random sample consisted of 289 members, approximately 1/6 of those in the builder/contractor/renovator category. Sixty-seven responses were received for a response rate of 23.2%.

The Carpenters Bargaining Conference and the Ontario Acoustical and Drywall District Council (CBC) included in the underground economy the practice of engaging a worker as an "independent contractor," which allows the employer to avoid the payment of employer taxes. Labour costs were thought to be as much as 40% to 55% lower in the underground economy. There was less difference in overall costs because of increased and more efficient organization aboveground.

When asked what percentage of the total provincial construction business was carried out underground, the CBC said that a figure was hard to calculate. Their information leads them to believe a large percentage of non-union work is performed underground. (The CBC made it very clear that it did not mean to imply that non-union meant underground.)

Beverage Alcohol

The Liquor Control Board of Ontario (LCBO) has 37% of the province's \$5.4 billion a year market in wine, beer and distilled spirits. Sales have been steadily falling for more than a decade, particularly in spirits. This decline has averaged approximately 5% annually since the late 1970s. While it is due to a variety of factors, the underground economy has recently become a major competitor.

The LCBO is affected by two types of underground activity. Alcohol, primarily spirits, is smuggled into Ontario, with most being sold through commercial, licensed outlets. The United States is the major source. The second type of activity is the illegal manufacture and sale of wine products within the province. These products are commercially produced in large volumes and enter the underground through licensed establishments.

Studies and surveys conducted by the LCBO suggest that approximately 15% of Ontario's beverage alcohol market is part of the underground economy. More than \$800 million in illegal sales translates into approximately \$475 million in lost

taxes. Over a recent 12-month period, illegal alcohol seizures from licensees increased by approximately 3,000% on an annualized basis.⁸

LCBO representatives were asked if it might not be possible to work with the manufacturers of wine bottles, caps and closures to estimate the number of legal and illegal purchasers of these products. Committee members were told that much of the illegal wine was sold in bulk in plastic containers and barrels. Bottles are borrowed not bought. Juice is brought across the border in bulk in tanker trucks and railway cars and then made into wine. Spirits are also moved across the border in bulk. Falsified waybills and invoices, and counterfeit labels allow products to move tax-free across both sides of the border.

The Association of Canadian Distillers (ACD) represents all of the country's major distillers. The industry has a direct and indirect economic impact of \$800 million on the province of Ontario. Sixty-five percent of its \$311 million worth of exports are shipped from this province. According to the ACD, 45.8% of the taxes the province collected from beverage alcohol sales in 1990/91 came from spirits in 1990/91.

Additional ACD figures showed that Ontarians consumed 20% less spirits in 1992 versus 1981. According to the ACD, the LCBO reported a 46% decline in the sale of spirits over that same period of time. The ACD attributes the difference to the underground economy. It estimates that of the seven million cases of spirits sold annually in Ontario, two million are sold illegally. When questioned, the ACD said its estimate of two million illegal cases could be low; it might be as high as three million. This revision is due to the fact that product comes across the border in 2,000 gallon tanker trucks, as well as in bottles. The ACD was

⁸The LCBO sent a letter to the Standing Committee on Finance and Economic Affairs on December 2, 1993. It reported that more than 36,000 illegal bottles of liquor and 12,000 illegal litres of wine were seized over an approximately five week period between the first week of November 1993 and the middle of December 1993. The seizures were made by staff of the LCBO's Investigative Services Unit, in conjunction with other law enforcement agencies, and were worth an estimated several hundred thousand dollars.

asked what percentage of the illegal product was made in Canada. It estimated domestic production to be between 1% and 2% of the total.

A third perspective on beverage alcohol was provided by representatives of the Ontario Provincial Police (OPP) stationed in the Cornwall area. While other border points are experiencing smuggling and criminal activity, Cornwall is thought to be the center of such occurrences in Canada.

(Cornwall is a unique border point in that it has as a neighbour the Akwesasne First Nations Territory. The Territory is contained within the provinces of Ontario and Quebec, and the state of New York.)

The OPP is part of an anti-smuggling task force which became operational in the Cornwall area on October 12, 1993. Led by the Royal Canadian Mounted Police (RCMP), other task force members are the Cornwall Police Service and Canada Customs. Contacts are being made with and assistance is being provided by other enforcement agencies in the region.

In the five weeks leading up to their presentation, witnesses said that approximately 5,000 16-oz bottles of liquor had been seized in the Cornwall area. A recent four week period had seen 4,000 60-oz bottles seized. Liquor traditionally represents less than 10% of contraband in the area, but the figure is rising. Almost all of the contraband liquor in the Cornwall area is manufactured by American distillers. Some is purchased from distillers with some of the tax paid, then smuggled without further taxes being paid. Large quantities of tax-free liquor are brought from the United States by bonded carriers with falsified papers.

Tobacco

According to witnesses, large quantities of Canadian cigarettes are being shipped tax-free to the United States and then smuggled back into this country. The Ministry of Finance told the Committee that export sales of Canadian-

manufactured cigarettes to the United States totalled 1.6 million kilograms in 1990. In the first six months of 1993, the figure was 9 million kilograms. The OPP reported that approximately 10% of the cigarettes smuggled through Cornwall are manufactured in the United States.

In their presentation, the Ontario Flue-Cured Tobacco Growers Marketing Board (OFCT) stated that 1 in 176 cigarettes sold in Canada in 1986 was contraband. They estimated that the ratio today is 1 in 6, possibly 1 in 4. Witnesses went on to say that 12 to 16 billion illegal cigarettes were sold in Canada in 1992. An increase was expected in 1993. The OFCT told the Committee that the loss to legitimate retail markets and governments is approximately \$2 billion. It estimated that Ontario may have lost as much as \$200 million in revenues in 1992. That same year, the loss for Ontario tobacco growers could be as high as \$35 million at the farm gate or approximately \$23,000 per producer.

The issue of "copycat" cigarettes was introduced by the OFCT. These are cigarettes blended to simulate the taste of the Canadian-manufactured product. They are packaged under a number of brand names and are manufactured exclusively for the Canadian "black market." (Packaging often resembles that of popular Canadian brands.) Copycats may or may not contain Canadian-grown tobacco. They are manufactured in Canada and "off-shore." According to the OFCT, 45.4% of the illegal cigarette seizures in 1992 were manufactured outside of the country; 63% of these foreign products were copycats.

Both the OPP and the OFCT spoke of the Akwesasne First Nations Territory in the context of contraband tobacco products.⁹ The Territory spans an international border and an inter-provincial border. According to the OPP, First Nations

⁹The OFCT also referred to the Six Nations First Nations Territory. Members are aware of recent reports that Six Nations people are interested in manufacturing cigarettes on their reserve and expressed concern about the possible impact this development could have on government tobacco revenues. (According to Revenue Canada, a manufacturer must be licensed before this activity can take place. Information provided by Revenue Canada, Toronto.)

people in the United States are allowed to purchase unlimited quantities of tax-free tobacco products and these purchases are to remain on reserves and are for personal use only.

The OPP went on to report that tobacco products are smuggled into Canada by boat or land from the United States to Cornwall Island (Akwesasne) where they are stored and then shipped to mainland Canada. Products are also smuggled directly from the United States to mainland Canada. The OPP told the Committee that an estimated 50,000 cartons of cigarettes cross the St. Lawrence River in the Cornwall area every day. Once in Canada, they are distributed to points across the country.

Tobacco and Beverage Alcohol Tax Status of First Nations People

First Nations people in the province of Ontario are exempt from paying provincial tax on unmarked tobacco purchased on reserves for personal use. The tobacco available on reserves is part of an annual base allocation that is given to each band in the province. The formula used to calculate the annual base allocation provides for tobacco for on and off-reserve band members. (It is illegal to sell unmarked tobacco to non-First Nations people.) There are circumstances under which the allocation can be increased:

- 1) by 10% for special events and occasional sales to other First Nations people; and
- 2) by a further 20% if the band council signs a retailer agreement to allocate the supply and monitor the sale of unmarked tobacco by retailers on the reserve. (If the band council does not sign a retail agreement, the Ministry of Finance will allocate the supply to retailers.)¹⁰

¹⁰Information provided by Motor Fuels and Tobacco Tax Branch, Ministry of Finance, Oshawa. Native people in Ontario have no tax-exempt privileges with respect to the purchase of beverage alcohol products. Information provided by the Liquor Control Board of Ontario, Toronto.

Most native people have the same status as other Canadians when bringing goods across the border from the United States. Residents of Akwesasne, however, are granted a special status under federal Order in Council 1991-1129, the *Akwesasne Residents Remission Order*.¹¹ Under section 4. of the Order,

remission is hereby granted of the duties paid or payable in respect of goods for personal use that are imported into Canada by an Akwesasne resident.

The owner or operator of a duly authorized community store and the Mohawk Council of Akwesasne or an entity authorized by the Council have somewhat similar privileges. In both cases though, the remission is not applicable to alcoholic beverages, cigars, cigarettes, or manufactured tobacco.

REASONS FOR CONCERN

There was agreement among many witnesses that all taxpayers were victims of the growing underground economy. While some felt that the situation could only get worse, others stated that there was no reason to panic.

Presenters gave a number of reasons why the underground economy was of concern to their specific area of activity. Those concerns of a broader application could be divided into two categories: economic and social.

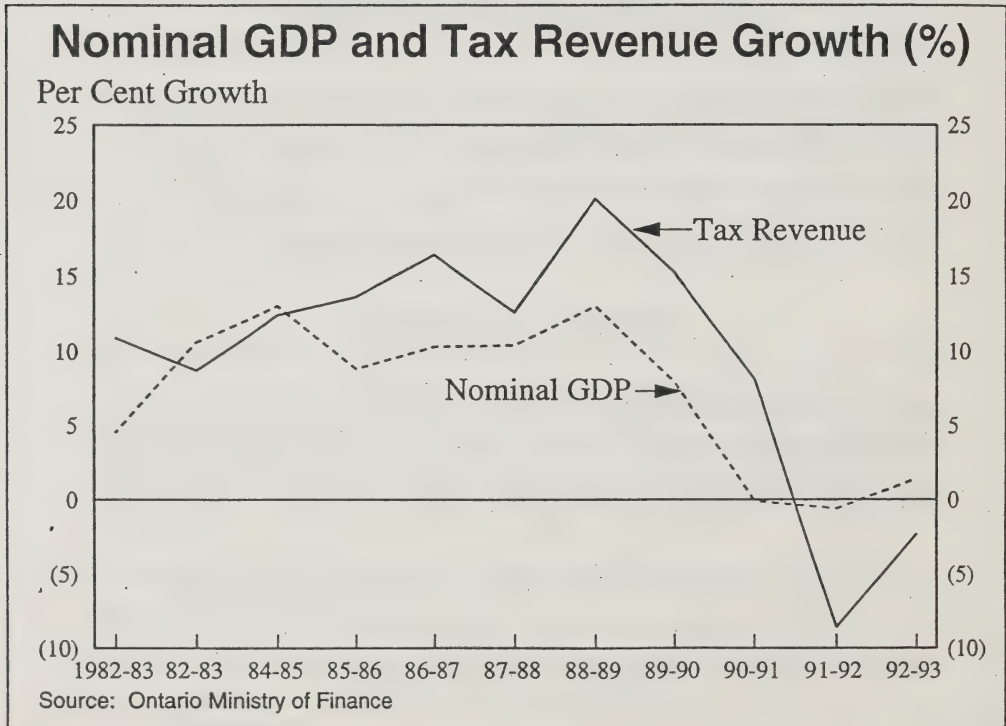
Economic

The underground economy, specifically tax evasion, results in decreased government revenues. Less money coming in means greater deficits and fewer dollars available for programs and services. The Ministry of Finance provided the Committee with a graph showing percentage growth in nominal GDP and tax

¹¹Information provided by Revenue Canada, Ottawa.

revenue between 1982/83 and 1992/93, inclusive. (See Graph 1.) Tax revenue growth dropped below zero between 1990/91 and 1991/92. The decline continued through 1991/92; there has been a return to growth in the time since.

GRAPH 1



Since its appearance before the Committee in October 1993, the Ministry has been able to calculate specific revenue impacts. Tobacco revenues have fallen by approximately \$188 million over the past two years. The decrease is attributed to increased smuggling and shifting consumption patterns. LCBO profits are down

\$90 million from a 1991/92 peak. The provincial sales tax has experienced a revenue loss of \$300 million to \$500 million.¹²

Another concern related to government was the misrepresentation of official indicators. Without a grasp of the size and influence of the underground economy, questions could be raised about the accuracy of statistics on unemployment, GDP and inflation rates. This in turn affects the policy development process that relies on such data.

The viability of the tax system, which relies on self-assessment and a reasonable level of honesty, is compromised if unreported income becomes a large share of total income. Some witnesses expressed concern that a taste for cheating on taxes could spread to other types of transactions. Roger Smith related the results of studies done in the United States which have shown that younger taxpayers are more likely to report non-compliance. Members of the Committee agreed that this did not bode well for the future.

Legitimate businesses, already coping with hard times, face increased competition from the underground economy. For example, tobacco farmers expressed fears about the future of their way of life and those of their local communities.

Social

Public safety at the provincial and the local level was a concern for a number of witnesses. Members heard of growing crime networks and threats of theft and violence. Representatives from the OPP felt that the penalties for smuggling were minor given the potential for financial gain involved. The Committee heard that those networks participating in the smuggling of tobacco and alcohol have the potential to move to other commodities, such as drugs and guns. Witnesses spoke

¹²This information was contained in a written presentation made to the Standing Committee on Finance and Economic Affairs on January 19, 1994, by the Minister of Finance.

about store owners whose stock has become targets for thieves and whose employees have become victims of violence.

Members and witnesses alike were concerned about the growing social acceptability of participating in underground activities and the development of damaging habits, particularly among the young. The latter could become ingrained, if not already institutionalized, hard to break and transferrable to other commodities. In response to questioning, Jack Mintz said that in theory one would expect that a reduction in tax rates would not result in a comparable reduction in underground activity. This would be due to the cost expended in learning how to cheat and the cost of establishing activity networks.

"Sin" taxes were seen by many, both witnesses and Members, as a health as opposed to a revenue measure. Any decrease would undermine tobacco and alcohol control strategies. The increased availability and consumption of these products, to whatever degree as a result of underground practices, was cited as leading to higher health risks and costs. The young were described as particularly vulnerable to the availability of cheaper tobacco and alcohol products as they are considered the most price-sensitive segment of the population.

An additional health risk was identified by the LCBO. Smuggled goods do not go through any vigorous testing by that agency. Investigators have discovered higher than allowable alcohol levels in some of the products that they have seized. Others have been stored in receptacles that previously contained items such as industrial chemicals and anti-freeze.

Representatives from the construction industry spoke of matters related to occupational health and safety. No employer taxes are paid in the underground economy. Employers and employees alike in the construction sector may pay less attention to health and safety and other labour standards for this and other reasons.

Witnesses and Members also discussed consumer protection and the underground economy. It was agreed that consumers purchasing both products and services in the underground did so at their own risk, without warranties, guarantees or any other form of protection.

CONTRIBUTING FACTORS

The Committee can only speculate on what causes underground activity and its speculations are based entirely on the testimony of witnesses. The current economic climate was cited by many as the major factor contributing to the development of the underground economy. Two key elements of that climate have also played a formative role: the tax system and perceptions of government.

The Economy

While a number of economic factors were discussed, two received special attention: the recession and unemployment. Before looking at these two issues though, consideration will be given to some changes in the formal and informal economies that witnesses felt put the underground economy in some context.

The small business sector was described by many as the one area currently experiencing growth. Technology has allowed for the development of more home-based businesses, greater numbers of people are self-employed and sub-contracting has become more commonplace. Employment relationships such as these see fewer employer tax payments being made. While they lead to greater flexibility, each of these characteristics was seen as conducive to greater participation in the underground economy.

Technological developments have led to increased computerization which has helped to decrease the costs of transactions. Transportation and communications have also benefitted. As a result, organizations are becoming more global. Conducting business at this level means that one government is no longer the only

legal authority dealing with a business. Several can be involved and they rarely cooperate in the exchanging of information. This situation was viewed as facilitating tax avoidance through intercorporate transfers.

The Recession

Ontario has suffered through a severe recession. According to the Ministry of Finance, the province experienced a peak to trough decline in GDP of 8%. Ontario lost 70% of the total Canadian jobs lost during that decline. The prognosis is for continued growth in the provincial economy, but restructuring continues as well. While 116,000 jobs have been gained since April 1992, that number is only 1/3 of those lost through the recession-induced decline.

The sluggish economy has provided many with a greater incentive to participate in the underground economy. Consumers and producers have both developed a least-cost, best-deal philosophy.

Unemployment

Unemployment remains high in Ontario despite the opinion of many that the recession is over. Unemployment and underemployment mean that a large number of bodies are available to participate in the underground economy. In the words of the OHBA, "Every time a plant lays off 1,000 workers, there are 1,000 new home renovators and home builders." Members were concerned that this situation could become a trend as economic forecasts refer to the "jobless" recovery and see little change in the unemployment rate for some time to come. Qualified tradespeople and older unemployed without education may have no where else to go.

Many residents of Ontario are recipients of unemployment insurance or social assistance. Both systems were described as inflexible in that they discouraged

people from re-entering the workforce. Supplementary income goes unreported out of fear that entitlements will be lost.

Tax System

While many common themes related to tax systems at all levels of government emerged during the hearings, four seemed to be singled out as contributors to the underground economy: general levels of taxation, tobacco and beverage alcohol taxes, the GST and PST, and fairness and compliance.

General Levels of Taxation

Taxation levels in general were described by many witnesses as high and rising. This growing burden was seen as one of the major catalysts for underground activity; the higher the rate of tax, the greater the incentive for tax evasion.

According to Roger Smith, personal income tax (PIT) as a share of personal income net of transfers rose from 15.2% in 1976 to 19.7% in 1990. Direct and indirect taxes rose as a share of GDP from 38% in 1976 to 43% in 1990. In Smith's opinion, Canadians are increasingly aware that tax as a share of GDP has been rising here while it has been steady or declining in many other OECD (Organisation for Economic Co-operation and Development) countries.

Moving from the national to the provincial level, the Certified General Accountants Association of Ontario (CGA) was asked to compare Ontario's taxes to those of its American neighbours. It saw the province as a costly tax jurisdiction, but also noted that consideration had to be given to the services provided publicly as opposed to privately on each side of the border.

The Ministry of Finance put Ontario tax rates in a national context. Using information from all 1993 provincial budgets, Ontario's corporate income tax rate (manufacturing) of 13.5% was found to be the fourth lowest in Canada. The

provincial PIT (combined federal-provincial rates) was the fifth lowest. (Rates for specific income brackets varied.)

Ministry personnel also told Committee members that there was little in the way of empirical studies of the relationship between tax rates and tax evasion. One American study, using Internal Revenue Service data, had correlated tax rates with amount of evasion. It discovered a statistically significant relationship but low elasticity. A tax rate cut of 10% would result in a 2% increase in voluntary reporting of income.

The Ministry reported that monetary studies have found that average rates are more relevant to the size of the underground economy than top marginal rates. People with the greatest underground opportunity are those in relatively small businesses, those with relatively low incomes and those in the middle tax range.

Tobacco and Beverage Alcohol Taxes

While much was said about general levels of taxation, witnesses also gave consideration to two specific types of tax: tobacco and beverage alcohol. Both were described as unfair and the major contributors to price differentials between products purchased legally in Canada and those bought in the United States or as contraband on this side of the border.

According to the OPP, smuggled cigarettes sell for \$20 to \$35 per carton in Canada. Ontario consumers are charged approximately \$45 for a legal carton. (American wholesalers pay approximately \$11 per carton for Canadian-manufactured cigarettes and then sell to distributors for \$14 to \$20 per carton.) Smuggled liquor sells for \$20 to \$25 per 60 oz bottle. A legal purchase of the same 60 oz bottle would cost \$40 to \$45. Canadian distributors are making purchases from American distilleries (with some taxes paid) for \$7 to \$9 per bottle. Alcohol destined for European countries can be purchased tax-free by bonded carriers for as little as \$2 per bottle.

The Association of Canadian Distillers (ACD) compared the prices of legal purchases of spirits in Ontario and in the United States. The average 750 ml bottle is sold for \$19 here. The same item would sell for \$9 in the United States. The ACD also told the Committee that approximately 83 % of the price of a bottle of spirits purchased at the LCBO was tax (approximately 23% federal and 60% provincial).¹³ Taxes in the United States account for approximately 42% of total price. Those who participate in contraband activities are not paying American taxes which adds even more to the price differential.

The LCBO referred to the perception that all liquor sold in the United States was cheaper than similar products available through its outlets. Surveys have shown that in many instances the LCBO is relatively price competitive. A recent price comparison of 254 products sold in Buffalo and at the LCBO found that 160 or 63% had lower prices in Ontario. (No product names were provided.)

The Ministry of Finance provided a comparison of provincial tax rates on tobacco and beverage alcohol products. Ontario compared very favourably. The taxes on a pack of 25 cigarettes were the second lowest in the country, as of October 21, 1993. Those for a case of 24 beer were the lowest, while those for a 1L bottle of Brights House white wine were second lowest and for a 750 ml bottle of Canadian Club were third lowest.

The Ministry also included a breakdown of the components of the tax on a carton of 200 cigarettes. The total cost was approximately \$47.42. The federal share (GST and excise tax and duty) was 39.5%. The provincial sales tax and tobacco tax combined represented 34.4% of the total. Manufacturers' costs were 14.8% and the retailer/wholesaler mark-up was 11.3%. Ministry staff concluded that smuggling would remain profitable even if the provincial taxes were eliminated.

¹³According to the ACD, spirits are taxed more than either wine or beer. While approximately 83% of the price of spirits is tax, the figure for wine is approximately 60% and for beer, 50%.

The Non-Smokers' Rights Association (NSRA) put Canadian tobacco taxes in an international context. It presented a table showing total tax incidence and the average retail price of a pack of 20 cigarettes in various countries, as of September 1993. Canada compared favourably with most international jurisdictions in terms of tax incidence, however, the United States was at the bottom of the range. When it came to the average retail price in Canadian dollars, Canadian prices were among the highest.

The NSRA spoke favourably of the federal tobacco export tax introduced in February 1992.¹⁴ This levy was repealed three months later after much protest. The NSRA also expressed optimism concerning an October 1993 announcement made by President Bill Clinton of the United States. He has proposed an increase of 75¢ (US) on the price of a pack of cigarettes to help finance his health care reform package.

The GST and PST

The federal government introduced its 7% goods and services tax (GST) in January 1991. The GST replaced and extended the invisible manufacturers sales tax (MST). According to witnesses, the GST's broad base, its introduction during a recession, and its application in combination with the 8% Ontario provincial sales tax, have all resulted in its being very unpopular. The Committee heard that the public has turned the tax into a touchstone for its dissatisfaction with an already complex system of taxation. It was the opinion of many witnesses that the GST was "the straw that broke the camel's back," providing many with the extra incentive needed to participate in the underground economy.

Witnesses told the Committee that the GST was originally commended as a self-collecting tax that would actually reduce tax evasion because of the paper trail it required. Input credits were to be claimed at each value adding stage of

¹⁴The tobacco export tax was introduced as a deterrent to smuggling.

production for the taxes paid at an earlier stage of production. The tax presumed that because the end retailers of goods had to pay the GST on all purchases, they would be compelled to charge the GST on final sales.

In the opinion of the Board of Trade of Metropolitan Toronto, the tax's flaw is its inability to provide incentives to the providers of services with low material input costs to charge the GST. The CGA spoke to this flaw as well. In the absence of what the CGA called "an effective, point-of-sale means to enforce compliance," consumers are unable to resist the temptation to evade the payment of the GST and the PST. Suppliers are equally motivated to participate, to make a sale and for tax reasons.

References were made to what were considered the GST's positive characteristics. It is lower than both the MST it replaced and the Ontario PST. Low-income earners receive a credit and a number of goods have a zero rating. Unlike the MST, it is visible. This visibility led Members to ask if the tax would have been more palatable had it been invisible. While some felt there might be advantages to invisibility on a theoretical level, the consensus was that visibility and consistency in the posting of prices were preferable to invisibility.

Fairness and Compliance

Two words were consistently used in discussions about the tax system: fairness and compliance. Professor Anthony Doob, Centre of Criminology, University of Toronto, told the Committee that they were separate concepts. While governments should strive for both, it should not be assumed that one will follow the other.

Satya Poddar, a tax consultant with Ernst & Young, presented the reasons why he felt there was a high degree of tax compliance in Canada. These included an efficient and honest administration, computerization, strict regulation of financial reporting, and the use of credit cards. His list was headed by public attitudes

which he considered supportive of the system. Taken together, they result in virtually zero non-compliance in the case of wages and salaries, and investment income.

Anthony Doob provided the Committee with statistics related to compliance. Professor Doob and Neil Brooks from Osgoode Hall Law School undertook a telephone survey of 1,908 randomly selected Ontario taxpayer households in 1990. Approximately 18.4% of respondents admitted to cheating on their income tax at least once in the previous three years. Non-reporting of income seemed to be the main way to avoid tax. Doob reported that approximately 80% of respondents said that they would not cheat, even if they could get away with it.

Doob and Brooks also examined the concept of fairness in the tax system. They identified seven independent contributors. (Seven was not to be considered a magic number; it reflected the limits of the survey methodology employed.) These included whether respondents felt they paid too much tax, whether the system of deductions was seen as fair, and whether government spends its money wisely. More than half (57.8%) of respondents felt the system was unfair, but 83.3% of these people were complying with tax laws. Among those who thought the system was fair, 79.1% said that they were complying.

The survey undertaken by Doob and Brooks predated the GST and the after-effects of the recent recession. Many witnesses who commented on the current situation felt there was a common perception that the tax system was unfair; that money is not being spent wisely by governments; that taxpayers are not receiving value for their money; and that the wealthy are not paying their fair share. "Everybody else is cheating or trying to."

The integrity of the system was said to be dependent on the goodwill and honesty of the taxpayer. If it is to continue to work, it must be perceived as fair. According to Roger Smith, it will not be perceived as fair when underground activity is sizeable.

Perceptions of Government

Governments at all levels were described as wasteful and lacking in credibility. They were perceived as being less dedicated to the causes of cost-effectiveness, value for money, rate of return, control, and accountability. Recent cuts in the private sector were not seen as being matched in the public sector. Businesses saw themselves as heavily burdened with legislation, regulation and red tape. Voters were dissatisfied with the conduct and performance of both governments and politicians.

Members contributed comments they have heard or received from constituents: people are unhappy, they pay their basic taxes but try to make whatever is left go as far as they can, and if they can avoid the payment of additional taxes, questions of guilt and illegality are not considered important. These sentiments had resonance with the Doob and Brooks finding that unemployment insurance fraud, smuggling and claiming false deductions were all considered more serious offences than tax evasion.

CORRECTIVE INITIATIVES IN PLACE

The Ministry of Finance and the Liquor Control Board of Ontario (LCBO) advised the Committee of the initiatives that they have put in place to counteract the effects of the underground economy.

Ministry of Finance

The provincial government has introduced a number of anti-tax evasion actions and measures to combat tobacco smuggling, many through the Ministry of Finance. The former include Project Fair Share which expands the number of audits and collections aimed at businesses. Another program has been introduced to increase publicity for successful tax-evasion prosecutions. Late-filed, late-payment and negligence penalties will not be assessed in voluntary disclosure

cases; the payment required will be the tax due, with interest. Joint investigations are being conducted with police forces and other ministries.

Among the measures to combat tobacco smuggling is the approved hiring of ten additional investigators and five inspectors. The Minister of Finance introduced amendments to the *Tobacco Tax Act* in November 1993 which include expanding the powers of detention and seizure, and increasing civil penalties.¹⁵ The province is participating in the joint anti-smuggling task force operating in the Cornwall area. It is also strengthening cooperative links with the federal government to combat smuggling and the sale of contraband cigarettes and liquor.¹⁶

Liquor Control Board of Ontario

The LCBO established an illegal alcohol task force in 1992. Members of the LCBO's investigative staff meet monthly with representatives from the RCMP, the OPP, the Ministry of Revenue, Revenue of Canada, and the Liquor Licence Board of Ontario. Contacts have also been made with the LCBO's counterparts in the United States.

RECOMMENDATIONS

The underground economy is a major and growing problem. The deterrents to its growth are multi-faceted. Witnesses made a wide range of suggestions which Members of the Committee examined and discussed, along with other testimony.

¹⁵The *Revenue Enforcement Statute Law Amendment Act, 1993*, received first reading on November 29, 1993.

¹⁶The Ministry of Finance provided information in October 1993 and on January 19, 1994, in a presentation to the Standing Committee on Finance and Economic Affairs made by the Minister of Finance. Smuggling became an enterprise crime under the federal *Criminal Code* with the proclamation of Bill C-102, *An Act to amend the Customs Tariff, the Excise Act, the Excise Tax Act, the Customs Act, the Criminal Code and a related Act*, on June 10, 1993. Property related to the proceeds of this crime can be seized.

Based on its limited study, the Committee developed the following set of recommendations. It wishes to emphasize though, that this is to not be considered a comprehensive list.

Taxation

1. A consensus should be developed on what constitutes a "fair" system of taxation.
2. Attention should be paid to the limits of public tolerance and the elasticity of the relationship between consumption and the rates of consumption taxes.

Government Accountability

3. Consideration should be given to establishing a legislative accountability framework within the public sector. To ensure accountability, the public must be made aware of the framework's existence and kept abreast of results.

Government Regulation

4. Regulation, particularly in the small business sector, should be kept as simple as possible.

Unemployment Insurance and Social Assistance

5. Unemployment insurance and social assistance programs should provide more support and encouragement to recipients who wish to work full or part-time.

Inter-Jurisdictional Cooperation

6. Governments at all levels, and their agencies, should cooperate to the greatest extent possible in sharing information considered essential to controlling the underground economy.

Tobacco

This area requires significant and immediate action. The Committee puts these recommendations forward for consideration by the government as part of its comprehensive plan for dealing with this issue.

7. The federal government should reimpose the tobacco export tax introduced in January 1992 and rescinded in April 1992.
8. The province should enter into an agreement with the federal government to ensure the collection of provincial tobacco taxes at the Canada-United States border by federal customs officials.
9. The Minister of Finance and other Cabinet ministers should participate in the development of a communications strategy to explain the fiscal and health rationale behind tobacco taxation policy.
10. Negotiations should be conducted with First Nations communities in areas of provincial jurisdiction with respect to enforcement, compliance and collection.
11. The provincial government should engage in discussions with the American federal government and the governments of neighbouring states to encourage them to raise their taxes on tobacco products.

Public Education

12. The province should develop and implement a broadly-based public education program focussing on the underground economy. Particular emphasis should be placed on its illegality and the harm it causes individuals and society. An attempt must also be made to establish a link between taxes, and services and benefits.

Enforcement/Compliance

13. Audit surveillance should be increased but only as long as it is effective. Enforcement/compliance might also benefit from the use of matched and cross-referenced data files, and additional information from tax filers.
14. The names of tax defrauders should be published.

Beverage Alcohol

- 15. Taxes on beverage alcohol products should not be increased.**

Further Research

- 16. The Ministry of Finance and others should be encouraged to conduct further research into the underground economy. Areas of study could include compliance, enforcement, sector-by-sector analyses, and audits. Consideration might also be given to the incorporation of taxes into posted consumer prices.**

APPENDIX A

**Reports on the Underground Economy
Summarized for the Standing Committee
on Finance and Economic Affairs**

REPORTS ON THE UNDERGROUND ECONOMY

- Brooks, Neil and Doob, Anthony N. "Tax evasion: Searching for a Theory of Compliant Behaviour." In *Securing Compliance: Seven Case Studies*, ed. M.L. Friedland. Toronto: University of Toronto Press, 1990, pp. 120 - 164.
- Canada. Dept. of Finance. *Jewellery Tax Evaluation Report*. [Ottawa: Ministry of Supply and Services], July 1993.
- , -----, *Tobacco Taxes and Consumption*. [Ottawa: Ministry of Supply and Services], July 1993.
- Clayton Research Associates Limited. *The Effect of the GST on Black Market Renovations*. Toronto: Clayton Research Associates Limited, January 1993. (Prepared for the Canadian Home Builders' Association.)
- Ernst & Young. *Jewellery Excise Tax Study*. Ottawa: Department of Finance, [1992].
- Éthier, Mireille. "The Underground Economy: A Review of the Economic Literature and New Estimates for Canada." In *Income Distribution and Economic Security in Canada*, ed. François Vaillancourt. Toronto: University of Toronto Press in cooperation with the Royal Commission on the Economic Union and Development Prospects for Canada, 1985, pp. 77 - 109.
- L'Association des manufacturiers du Québec. *L'Economie souterraine au Québec*. Montreal: L'Association, août 1993
- Karoleff, Vladimir; Mirus, Rolf; and Smith, Roger S. "Canada's Underground Economy Revisited: Update and Critique." Paper presented at the International Institute of Public Finance (IIPF), 49th Congress, Berlin, 24 August 1993.
- Lindquist, Avey, Macdonald, Bakerville, Inc. *1992 Contraband Estimate - An Update*. Toronto: Lindquist, Avey, Macdonald, Bakerville Inc., September 1993.
- Spiro, Peter. "Evidence of a Post-GST Increase in the Underground Economy." *Canadian Tax Journal* 41:2 (1993): 247-258.
- Stamler, Rodney T. *Contraband Tobacco Estimate - June 30, 1992*. Toronto: Lindquist, Avey, Macdonald, Baskerville Inc., October 1992. (Prepared for the Canadian Tobacco Manufacturers' Council.)

APPENDIX B

Dissenting Opinion of Elinor Caplan, M.P.P., Monte Kwinter, M.P.P. and Gerry Phillips, M.P.P.

STANDING COMMITTEE ON FINANCE AND ECONOMIC AFFAIRS - LIBERAL MINORITY REPORT

The Liberal members of the Standing Committee on Finance and Economic Affairs are in basic agreement with the Committee's report on the underground economy.

We believe, however, that the report should have made a stronger link between the current high rate of direct and indirect taxes in Ontario and the province's growing underground economy.

For the past three years, Ontarians have endured more than 30 tax and fee increases under the current government. Provincial income tax rates have soared. Workers' Compensation premiums for employers have risen sharply during the past two years. And fees have risen exponentially as the government scrambles for revenue to fund its string of \$10 billion deficits.

The people of Ontario have become increasingly upset over higher taxes and the wasteful spending programs that this government is funding with those tax revenues. As a result, Ontarians are more willing to engage in contraband activity. The attitude of many people is "I am not going to give the government any more of my tax dollars".

The province must break this mood of cynicism among taxpayers if the government is ever to halt the growth in the underground economy. It must be a priority of the government to attract those people currently engaged in illicit activity back to the legal economy.

To accomplish this goal, however, the provincial government must place a cap on further tax increases. Taxes cannot go up further and, in the long-term, must be reduced if people are to give up the lucrative profits in the underground market and return to the legal economy.

Ontarians are law-abiding people. What has driven many of them into the underground of economy is the current high rates of direct and indirect taxation by this government. The government must commit to not increasing taxes as a first step to attract these people back to the legal economy.

Recommendation: In order to reduce the underground economy, the government must commit to not increasing taxes and set, as a long-term goal, lowering taxes.

APPENDIX C

Dissenting Opinion of Gary Carr, M.P.P. and W. Donald Cousens, M.P.P.

DISSENTING OPINION OF THE PROGRESSIVE CONSERVATIVE MEMBERS
STANDING COMMITTEE ON FINANCE AND ECONOMIC AFFAIRS
REPORT ON THE UNDERGROUND ECONOMY IN ONTARIO
FEBRUARY, 1994

RECOMMENDATIONS

1. *The government not increase any taxes , fees or charges nor impose any new tax or non-tax revenue measures in its 1994-95 budget..*
2. *The government of Ontario should support the government of Canada's four point program to combat contraband trade and reduce its tobacco tax as part of a national effort to undercut the black market for cigarettes.*
3. *The government of Ontario should adopt a balanced budget law modelled on the type introduced in New Brunswick and Alberta.*
4. *The government of Ontario develop and implement a Citizens' Code of Regulatory Fairness like the one adopted by the federal government of Canada. As with the federal model the code should commit the government to certain principles including to interfere as little as possible with individual freedoms while protecting the interests of the community.*
5. *The government of Ontario should issue the provincial equivalent of the Federal Regulatory Plan which would provide the public, businesses and other interested parties with advance notice of the intention of a ministry of the government to make a regulation and provide interested parties with the opportunity to scrutinize the regulation to determine whether it is necessary.*
6. *The government of Ontario should follow the lead of the government of Newfoundland and appoint an independent arms length committee to review with government officials all government regulations that effect businesses and introduce a sunset provision to come into effect on April 1, 1995 at which time all regulations found by the committee to be either inappropriate, irrelevant or unduly onerous shall expire.*
7. *The government of Ontario should eliminate the \$50 corporate registration fee as the compliance costs are far greater than the fee itself.*
8. *The government of Ontario should move to eliminate the economic, administrative and compliance costs of a dual sales tax system by working with the federal government to develop a national sales tax and should commit to apply any additional revenues generated by the introduction of such a tax to the reduction of the provincial income tax rate.*
9. *The Minister of Finance should include in the provincial budget and the annual economic forecast information on [a] estimates of the size of the underground economy in Ontario [b] the primary sectors in which underground activity is most prevalent [c] estimates of the revenue impact by type of tax.*

Will Roger's observation that taxes have made liars of more people than golf as never been truer than today.

While there is some uncertainty about the size and economic and revenue costs of the underground economy in Ontario, the consensus which emerged during the Committee's hearings was:

[a] that the underground economy was bigger than ever,

[b] that the underground economy was expanding more rapidly than ever,

[c] that participation in the underground economy was not regarded as either illegal or immoral by a growing number of Ontarians and,

[d] that the size and growth of the underground economy was at least partially the fault of the very governments that today bemoan its existence and its impact on their revenues.

There was also a high degree of consensus on the causes for the surge in underground economic activity. The primary causes from our perspective are high taxes, costly regulations and growing public dissatisfaction with way governments spend, manage and account for the billions of tax dollars they continue to collect.

We are submitting this dissenting opinion to address what we see as the serious deficiencies in the majority report's recommendations on the measures the government should take to deal with a problem which witnesses described as a "tax revolt" and as "social anarchy".

The majority report, while it agrees on many points with the assessment outlined above of the

financial and psychological factors and incentives which drive the expansion of the underground economy ignores the logical implications of its own analysis and, on key points, offers only insipid recommendations for action.

Moreover in other areas the majority report provides the government with general platitudes where specific measures could have and should have been advanced.

TAXATION

Perpetually escalating taxes have increased incentives to go underground. Nowhere are these incentives greater than in the province of Ontario which the witness from the Certified General Accountants of Ontario [CGAO] described as “a costly tax jurisdiction.”

The province has gained this dubious distinction because in the past decade Liberal and NDP governments have punished Ontarians with 65 new or increased provincial taxes. In addition Ontario taxpayers have had to absorb more than 30 federal tax hikes and innumerable fee increases and municipal property tax hikes.

In the past three years alone the average Ontario family has seen their provincial tax bill increase by \$663 as a result of three NDP budgets. Over that same period the top marginal income tax rate has risen over to 52%, a level at which international tax studies have shown that people actively look to avoid or evade income taxes.

The effective tax rate [PST, GST and PIT combined] is over 60% which provides people with a powerful incentive to evade or avoid taxes.

Clearly, if government's aims are to keep people in the formal economy and to shrink the

underground economy then it cannot keep increasing the tax burden.

Yet the majority of the committee could not support the modest goal of a general freeze on all revenue measures and settled for recommending that "A consensus should be developed on what constitutes a "fair" system of taxation."

We thought that was what the Fair Tax Commission had spent \$8.2 million and three years doing. However, the majority of the committee and, by extension the government, still doesn't seem to get the message that people are going underground not because they think that the taxes are "unfair" in some abstract sense but because they believe that they are being overtaxed in a very concrete sense.

The government just doesn't understand - the average Ontarian thinks that taxes are unfair because taxes are too high.

The first step to making taxes fairer is to make them lower and the first step toward reducing underground economic activity is to develop a plan to reduce the tax burden.

At minimum, the government must not increase any taxes or fees in its next budget.

Recommendation #1

The government not increase any taxes , fees or charges nor impose any new tax or non-tax revenue measures in its 1994-95 budget..

Tobacco Taxes

The issues of tobacco taxes and cigarette smuggling received considerable attention during the

Committee's hearings. Since the Committee wrote its report the federal government announced a four point plan to attack the contraband trade which is costing the federal and provincial governments an estimated \$2 billion annually, is endangering citizens in border communities and is undercutting legitimate small businesses.

We believe that the federal plan to be successful must be national in scope. Failure to participate would make Ontario a smugglers' haven and the province must join the effort to weaken the contraband market by cutting taxes.

The province should also support public education and enforcement programs in its jurisdiction.

Recommendation #2

The government of Ontario should support the government of Canada's four point program to combat contraband trade and reduce its tobacco tax as part of a national effort to undercut the black market for cigarettes.

SPENDING CONTROL AND ACCOUNTABILITY

Public disenchantment with government spending practices is another factor which contributes to and legitimizes underground economic activity.

As the Ontario Chamber of Commerce [OCC] Brief put it, a common sentiment is that "A lot of money that is collected in taxes is wasted by the Government."

The Canadian Federation of Independent Business went further and suggested that, "Recent government performance has led some to believe that maybe underground economic growth is not a bad thing from an economic perspective, since monies kept out of the hands of governments will at least be used more efficiently than if spent by governments."

This may be an extreme view but is indicative of the level of public cynicism about governments' spending practices and priorities.

In Ontario this cynicism has been strengthened by the recent refusal of the Provincial Auditor to give an unqualified endorsement to the public accounts, a development which confirmed the widely held suspicion that the government has something to hide.

People will be loathe to hand over their hard earned dollars as long as they suspect that they are being fooled by a government which is cooking its books to cover-up inept management.

The majority report wants to deal with the credibility problem by establishing a legislative accountability framework.

While this is a worthwhile measure, and was advocated by the Provincial Auditor, it does not adequately address the broader macro-issue of accountability for the over-all fiscal policy of the government.

Nor does this measure address the fundamental problem of the level of government spending which must be reduced and constrained if we are to achieve the tax cuts necessary to stimulate growth and employment in the formal economy.

For the past number of years in a series of pre-budget reports, we have called for a more stringent spending policy. We believe the time has come for a statutory limitation on the government's penchant to tax and spend.

A balanced budget law would make strengthen accountability and provide the public with a yardstick with which to measure the government's performance as a financial manager.

Recommendation #3

The government of Ontario should adopt a balanced budget law modelled on the type introduced in New Brunswick and Alberta.

REGULATORY REFORM

The regulatory burden and the compliance cost associated with it were identified as another factor which contributed to the growth of the underground economy. As the OCC put it, "The costs imposed by regulation are just as damaging as those imposed by taxes."

It was also noted by a number of presenters that these costs were especially onerous for small businesses.

If the policy objective is to stimulate growth, job creation and business start-ups in the formal economy then it would follow that government should make it as simple and as affordable as possible to operate in the formal economy, particularly for small businesses who are the primary generators of new jobs.

It seems however that the exact opposite is the case.

The government of Ontario passes between 750 and 1,000 new regulations every year. The cost of these regulations to Ontario businesses has not been quantified but, through our consultations with small businesses and entrepreneurs as part of the mandate of the **Mike Harris Task Force on Creating Jobs through Small Business**, we know the regulatory burden is a matter of genuine and growing concern .

We also know from surveys done by groups like the CFIB, and from the government itself in some cases, that small and medium sized businesses invest considerable amounts of time and resources in coping with the regulatory burden and the paperburden - time and resources that could be much better spend making the business more profitable and productive.

Some regulations are particularly irksome. The compliance costs associated with the dual sales tax system [the PST & the GST] and the corporate registration fee were singled out as major irritants before both the Committee and our Task Force.

On the regulatory issue, the majority report simply recommends that "Regulation, particularly in the small business sector, should be kept as simple as possible." This provides little in the way of direction to the government.

It seems to us that the challenge is to develop a policy and process which will eliminate all current regulations which are either irrelevant, unnecessary or unduly onerous while ensuring that all future regulations are subject to an economic and competitiveness test.

This will require a major overhaul of the regulatory process in Ontario. Currently, the province has no formal policy governing the development of regulations, there is no formal planning process that would warn the government or the public about a regulation that might be introduced, there is no mandatory requirement for public consultation or notification (unless explicitly provided for under the Act authorizing the regulation), the Legislature has no direct input into developing regulations, there is no requirement that the government evaluate the regulations and there is no economic impact analysis of the regulation.

Other governments in Canada have acted aggressively to streamline their regulations - to open up the process and to protect against regulations which would undermine their broader economic policy objectives.

Governments like the federal government and the government of Saskatchewan have developed codes or guides of regulatory fairness and others like the governments of Alberta and Newfoundland are in the process of reviewing their regulatory regimes with the objective of eliminating all obsolete regulations and those which have a negative impact on businesses.

Recommendation #4

The government of Ontario develop and implement a Citizens' Code of Regulatory Fairness like the one adopted by the federal government of Canada. As with the federal model the code should commit the government to certain principles including to interfere as little as possible with individual freedoms while protecting the interests of the community.

Recommendation #5

The government of Ontario should issue the provincial equivalent of the Federal Regulatory Plan which would provide the public, businesses and other interested parties with advance notice of the intention of a ministry of the government to make a regulation and provide interested parties with the opportunity to scrutinize the regulation to determine whether it is necessary.

Recommendation #6

The government of Ontario should follow the lead of the government of Newfoundland and appoint an independent arms length committee to review with government officials all government regulations that effect businesses and introduce a sunset provision to come into effect on April 1, 1995 at which time all regulations found by the committee to be either inappropriate, irrelevant or unduly onerous shall expire.

Recommendation #7

The government of Ontario should eliminate the \$50 corporate registration fee as the compliance costs are far greater than the fee itself.

Recommendation #8

The government of Ontario should move to eliminate the economic, administrative and compliance costs of a dual sales tax system by working with the federal government to develop a national sales tax and should commit to apply any additional revenues generated by the introduction of such a tax to the reduction of the provincial income tax rate.

FURTHER RESEARCH

The underground economy will not vanish overnight and the majority report recommends that the Ministry of Finance and others be encouraged to conduct further research into this phenomenon.

We would add that, particularly if the Ontario government participates in the federal four point plan which would involve the commitment of public resources the Minister of Finance should report on the progress of efforts to combat underground economic activity and the impact of the underground economy on provincial revenues.

Recommendation #9

The Minister of Finance should include in the provincial budget and the annual economic forecast information on [a] estimates of the size of the underground economy in Ontario [b] the primary sectors in which underground activity is most prevalent [c] estimates of the revenue impact by type of tax.

CONCLUSION

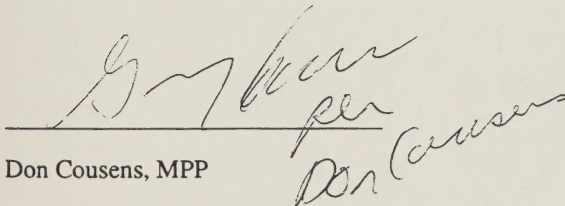
In trying to stem the growth of the underground economy the government should heed the words of John Bulloch of the CFIB who told the Committee, "*The only means of attacking underground economic expansion is to treat the disease, not the symptoms. . . . The only enduring solution will involve an overall reduction in the size of government, leading to a reduction in the level of taxation and the regulatory burden on small and medium sized businesses. This in turn will assist in reducing the resentment with which Canadians currently view their governments. Until the*

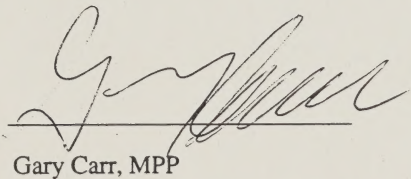
perception and reality of fairness is restored to Canadians, the underground economy will continue to thrive."

We agree.

The prescription for beating the underground economy is the same as the prescription for strengthening and sustaining growth in the formal economy - cut spending to cut taxes. The underground is only attractive because taxes have priced legitimate businesses out of the market.

If we concentrate on curing the disease of big spending, high taxing governments, we will not only go a long way toward wiping out the underground economy, but we will realize the additional benefit of a more competitive, productive and prosperous provincial economy capable of creating the jobs and opportunities Ontarians need and deserve.


Don Cousens, MPP


Gary Carr, MPP



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